

This is a memo written on September 22, 2008 by Dwight Sandlin, President & Owner of Signature Homes, a firm based in Birmingham, AL. Dwight sent this memo to the people in his organization. He entitled it ...

## "It's the Economy Stupid"

As we are all aware, the current happenings in the economic market have been confusing. The stock market plunges only to have a record return in two days. Then fall apart in the next two days! The government appears to have bailed out Bear Sterns, taken over Fannie Mae and Freddie Mac, let Lehman go bankrupt and finally buy 79.9% of AIG which is the largest insurance company in America. To say the market is confused is the understatement of the year.

The purpose of this writing is to let you know what I think is happening. Please understand, no one knows for sure, but at least you will know what I think. Hopefully it will help.

As opposed to discussing the alphabet of government agencies and security instruments, this is written with a fictitious cast that is fairly representative of how the market got to where it is today. The named purchaser is Mr. & Mrs. Sucker and the fictitious Wall Street firm is Dewey, Cheatum and Howe.

Before we begin our story, let's set the stage for how most of the financial markets were creating mortgages prior to Sub Prime loans being made.

In 1938 the Federal Government created the Savings and Loan Industry. It also created the Federal National Mortgage Association, FNMA (referred to as Fannie Mae). Fannie Mae was made a stock held company in 1968. For most of the years until the mid 1970's the S&L's provided a large percentage of permanent loans. The S&L industry failed in the 1990's and Fanny and Freddie Mac (Federal Home Loan Mortgage Association) became the primary source of secondary markets for mortgage loans. It was fairly simple and straight forward. A mortgage company would originate loans and sell them to Fannie, Freddie or other investors (these were the secondary markets). The yield was basically derived from the note rate on the loans. Fannie, Freddie or investors would hold the loans as long term investments.

The loans typically were made with an 80% loan to value. Anything over 80% required private mortgage insurance for the amount above 80%. Typically the maximum LTV was 95%.

During that time FHA loans were available, these were government owned loans. FHA was designed for those with weaker credit scores and would do up to 97% LTV. However, the underwriting was not easy.

The mortgage loan markets until 2002 were generally done in this fashion. Underwriting was pretty strict. Because of tight underwriting, mortgage backed securities were historically a very safe investment.

Now let's begin our story.

To simplify our story, let's take one home as an example:

The year is 2003, Harry P. Sucker, a prospective homeowner, decides to buy a home. Harry had neither been frugal with his money nor concerned about timely payments. He and his wife Susie Sucker live in an apartment which rents for \$850 per month and had a poor credit rating.

Harry and Susie decided they wanted to buy a home. Based on their credit scores and income, they would qualify for nothing, because they had no down payment and poor credit. Simultaneously, twenty other couples decided they wanted a house. They all were conscientious about paying their bills timely and began saving for a down payment on a home.

In 2003, the Wall Street firm of Dewey, Cheatum and Howe, was looking for a way to make a fast buck. These guys were all “well bred” Ivy Leaguers who wanted to make millions by the time they were 28 years old. At that time they realized that China, Japan and India, as well as the United States had more excess cash than ever before. These entities needed a company to invest the excess billions. Dewey, Cheatum and Howe was their firm!

In prior years, mortgages were made to credit worthy people, bundled into huge investment packages called mortgage backed securities (MBS) and sold as fixed income investments. A very boring system, but a stable one.

Dewey, Cheatum and Howe were very bright. They decided to put some excitement in these MBS (and at the same time charge huge fees to the investors). They decided to split these MBS up to give different investors what they wanted. A new term was devised: tranches.

They would sell off the MBS to various investors based on their appetite for risk via tranches. For example, let’s say that a MBS security totaled one billion and the total yield was 7%. They would devise different levels of return using tranches.

**Level I:** \$495MM to MET life insurance in the United States at 5%. For this lower rate MET would have a reduced risk. If default occurred they would be the first to receive their money.

**Level II:** totaling \$200MM was at 7%. Their position was second to Level I. They sold this to Fannie Mae.

**Level III:** was \$150MM at 9%. This was subject to Levels I and II being made whole before they received their money. This was sold to a bank in China.

**Level IV:** was \$100MM at 11%, which obviously was subject to Levels I, II and III being made whole before they get their money. This was sold to an investor in France.

**Level V:** was \$50MM at 13.5%. The riskiest level (but at 13.5% what the heck). It was sold to a brokerage house in Vietnam.

This new approach was very profitable (especially to Dewey, Cheatum and Howe). Dewey, Cheatum and Howe received a \$5MM fee for splitting the investment into tranches. Until mid 2004, the loan underwriting criteria was pretty normal. However, the investors from all over the world were clamoring for more places to invest. Soon Dewey, Cheatum and Howe (along with numerous other Wall Street firms) had huge groups of investors saying “take my money and invest it in mortgages” (historically a very safe investment). There simply was not enough people with good credit to fill the demand. Therefore, Dewey, Cheatum and Howe, began creating new types of mortgages. (i.e. Alt A, Interest Only, Sub Prime and No Doc 100% loans) As they decreased the standards in underwriting, a strange thing began to happen - the demand for housing went crazy. As demand rose exponentially, so did home prices. Home prices rose faster than any other time in history.

As prices rose, a new player came into the game - “flippers”. In many places like California, Phoenix, Las Vegas and Miami, investors were buying homes and “flipping” them to others at much higher prices. Between 1996 and 2006 the median price of a home in America rose 65% (a unprecedented rise). Everybody seemed happy because many people thought housing prices would always rise even though history showed prices have risen and fallen in multiple cycles. These “flippers” accounted for 20% of the market.

Because of the “new” demand the homebuilding industry flourished, national home stats were averaging 1.5MM per year. In 2004, 2005 and 2006, housing starts rose to approximately 2MM. The excess homes were bought by “flippers” and people like the Suckers.

During this time our friends in Congress were bragging about homeownership rising and the economy was doing great. There were a few people who tried to warn our congressmen and senators that there was a problem looming due to the exponential rise in home prices and loose underwriting standards. Many said that Fannie Mae and Freddie Mac were too large and were headed for trouble. However, Fannie and Freddie were savvy in the ways of Washington. They spent \$200 million dollars in contributions to congressmen so that the congress would see how silly these alarmists were. Therefore, Congress did nothing except brag about the high homeownership and accept contributions from Fannie Mae, Freddie and Dewey, Cheatum and Howe.

Back to our story.....

In 2005 Harry and Susie Sucker decided they wanted to try to buy a home again. To their amazement, they found that they could buy a \$200,000 home. They could get a No Doc loan at 3.5% interest only. The payment would be \$650 a month. No down payment was required. The home they were purchasing was recently bought by an investor for \$175,000 and the price was higher than all the other houses in the neighborhood, but what the heck. The loan would stay at 3.5% for a year and then rise to a fixed rate at about 6% which means their monthly payment would rise to \$1067. Mr. & Mrs. Sucker didn't care. In a year they would sell it for \$225,000 and pocket the money. The twenty other responsible people bought a house in 2005. They had saved their money and put down 5%. They shopped for the best value and bought their home for \$185,000. They got a 6% fixed rate loan that they could afford. They too thought prices would continue to rise, but even if they didn't, they could afford their payment.

The Suckers loan was packaged with the other twenty responsible people's loans and went to Dewey, Cheatum and Howe. They packaged these loans with other loans from all over the country. The packages altogether totaled 20 billion dollars. About 5% of the loans were to people who were as irresponsible as the Suckers. Dewey, Cheatum and Howe split the package to five different investor groups all over the world.

This time however, they made it a bit more complex. They got American International Group (AIG), the largest insurance company to write an insurance policy on the value of the mortgage loans to assure the investors from all over the world that these were safe investments. Simultaneously, Dewey, Cheatum and Howe, somehow convinced Moody's (a nationally known rating agency) to assign a AAA rating (the best rating possible). The only thing that was constant was that Dewey, Cheatum and Howe received millions in fees. What is interesting to note that Dewey, Cheatum and Howe did not invest in these AAA investments.

In 2006, the Suckers loan rolled into an ordinary loan payment of \$1300 per month. The Suckers struggled for a few months to make the payments, but ultimately defaulted on their loan. The plans to sell their home for \$225,000 failed. Because they had no equity, it was easy to walk away.

In 2007, the investors started to realize that these AAA investments in MBS's were not so good, so they quit buying the interest only Alt A and Sub Prime loans. Without a source for the Sub Prime loans, the huge demand for housing stopped. As quickly as it did, the "flippers" quit buying homes and dumped all their homes on the market at the same time. Almost overnight without the source of people like the Suckers who would not qualify for a loan and the huge number of "flippers" trying to sell their homes, the real estate market was glutted with inventory. To the horror of these people who thought real estate could not decline, the grim reality became apparent. The Suckers home was ultimately foreclosed, along with other Sub Prime borrowers. This problem increased tremendously by the "flippers" (who by now had bought multiple homes) who could not sell their houses and were foreclosed.

Once foreclosures occurred, the homes were put back on the market. Because the housing market was flooded with inventory, the prices began to fall. Losses began to rise. The problems began to become very complex to solve. Dewey, Cheatum and Howe had sold the investment instrument to five different investors.

Now the question is ... who takes the hit? Imagine how complicated this is to unwind, one \$200,000 loan to five different investors. Now think of it in a broader term, where there are over one million homes that were foreclosed. As these complexities occurred, the global market simply quit buying mortgage loans. The MBS's that these investors bought could not be sold in the global investment markets. Also, when the losses began to come, there was no one to service the loans. Dewey, Cheatum and Howe were not interested in solving the problem, because there were no fees to be made.

Fannie Mae and Freddie Mac are the largest investors of MBS's, about 50% of all Mortgage loans. They got heavily into the various sophisticated instruments. However, they apparently were not good bookkeepers (or were fraudulent in their actions to disguise losses) and ultimately charged off several billion dollars, which resulted in the firing of their CEOs a few years ago.

The real estate market continued to deteriorate in 2007 and 2008. Now we know that almost everybody in the financial markets, including the country's largest mortgage lender, Countrywide Mortgage, the largest investment bankers Bear Stearns, Lehman Brothers, Goldman Sachs and Morgan Stanley as well as the largest commercial banks like Citicorp, Wachovia, Indymac, were also investors.

During this melee, there was an accounting change that required the commercial banks to "mark to market" all their investments (including MBS's). What that means is that anyone who invested in MBS must determine the real value and adjust their balance sheet to reflect their value. The problem is very simple, there ain't no market for these MBS's - no one wants them. Because of the lack of liquidity in the market to sell them, they had to start writing them down. Lehman had marked down some of their portfolio by 80%. In the real world, an example of "mark to market" would be to have a home as an asset. "Mark to market" would mean that you sell your home in one day. There probably would be not be a market for a "one day" sale. If there was, the price would be **very** low. This is the same as marking to market in MBS.

Let's digress for a moment. Remember the package that Dewey, Cheatum and Howe assembled including the loan for the Suckers and the twenty people who secured ordinary loans that are still making monthly payments. On a national average only about 5-6% of all mortgage loans are in default. 94% are still paying their mortgages each month. However, because there are no investors buying, the market is beginning to freeze up. The MBS's have value, however, because of the complexity of the investment tools used to sell to the world wide investors, no one can predict what the real value of the remaining MBS's.

About a month ago, the Treasury Department realized that Fannie and Freddie were not going to survive. Both Fannie and Freddie were Government Sponsored Entities (GSE's). There had always been a "implied" guarantee by the Federal government but not a written guarantee.

Fannie and Freddie were hemorrhaging losses due to the "mark to market". The investor market began not to buy the mortgage loans from these GSE's because the investor market was afraid the government might not guarantee the loans. Hank Paulson (Director of Treasury) had the government wipe out the stock value of the GSE's and guarantee the loans. The GSE's now buy almost 70% of all new loans in America. Paulson knew that if no mortgages could be made, the country would fall into a worldwide depression, much like the depression of the 1930's. In my opinion, he had no choice.

The same is true with AIG. They were very heavy into insuring the defaults of the MBS's and had tremendous losses on their balance sheet due to the "mark to market" of the trillions of dollars in the investment portfolios. Also, AIG underwrites a huge percentage of hundreds of other insurance products. If they declared bankruptcy, the economy would have taken a devastating hit. That is why the government bought AIG. Many believe that given time AIG will be sold and the government will record its investment.

Last week Hank Paulson proposed a unprecedented move to create a National Bank, funded by \$700 billion federal dollars. The purpose of this bank is to allow American investment banks, as well as commercial banks (the details not yet revealed), to sell their MBS's to the federally funded bank. What this will do is allow the financial institutions to unload their illiquid assets so they can receive cash which will allow the banks to begin lending. At this time, these frozen bank assets causes illiquidity in the banking system which means that they can't lend money. If the banks can't lend money, our national economy stops!!

Hopefully, as the markets begins to unthaw, the government can sell the assets and recoup our money. The government did the same thing for Chrysler in the 1970's and the government actually made a profit.

This bank must be approved by Congress, which means that it will become a political football. Congress, as well as our presidential candidates, are blaming each other and Wall Street. They are acting like they were never warned. Typical of our Federal representatives.

These solutions engineered by Mr. Paulson were in the best interest of the country. While it is easy to blame Congress, Wall Street or even Dewey, Cheatum and Howe, there had to be investors, Mr. and Mrs. Sucker, the “flippers” and even builders who sold overpriced homes, to have made this fiasco come to pass.

The repercussions are easy to see:

- (1) The real estate market was over priced. Values are declining in those areas that were “too” hot.
- (2) Flippers tried to make money on a factiously high demand.
- (3) Mr. and Mrs. Sucker acted irresponsibly.
- (4) Wall Street provided liquidity to a market without regards for the damage it would do to the economy. They did so simply to make fees.
- (5) The commercial banks are reeling from the loans made to builders that now are worth much less than the loan amount.
- (6) The economy is in a mess. It will get worse before it gets better.

The purpose of this epistle is simply to give you a basic understanding of how I perceive the world got into its current economic position. Like everyone else, I am not certain of how all the change in events over the past month by the government will work out. Hopefully, we will see our economy strengthen in the near future.

Suffice to say, the “irrational exuberance” of the world investment community was too aggressive from 2002 until 2006. From 2007 to now, they are equally irrational about how bad the mortgages securities are today. I am looking forward to a more boring MBS market that uses tried and true methods of underwriting loans like it was for the 50 years prior to this bubble.

While all of this doom and gloom is frightening, the Birmingham economy remains very strong. Very few people in our market bought homes like Mr. & Mrs. Sucker. The biggest problem we have as a company is the fear of uncertainty in future buyers. We must continue to create “Raving Fans” and provide good counseling to our prospects so that they know buying a Signature home is the safest investment they can make. They also will enjoy the advantage of a great community and unique home.

I hope this information is helpful to you.

**P.S.**

Some of you are too young to remember the “DotCom” fiasco. It began in 1995 and ended in 2000. There were thousands of companies started (fueled by excess cash in the market). Their idea was to start virtual companies without brick and mortar. The primary market was the NASDAQ which rose to 5048, which was more than double its value a year earlier. The bubble burst in March and in just three days it lost 9% of its value. The DotCom bubble crash wiped out \$5 trillion in market value. Afterwards the companies came to the reality that a company must produce real results.

I perceive that the financial crisis will do much the same. When this mess is all over, it looks like we will be back to making reasonably risked mortgage loans and selling them into the secondary markets for long term investments.